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Comment on the upcoming data and forecasts

The forthcoming week will bring us the current account release on Wednesday. The income balance will be negatively influenced by the significant payment of public debt interests and transfers account by slightly lower EU transfers. Exports and imports accelerated modestly resulting in decent surplus in trade account. On Friday the CPI and M3 data will be released. Despite growing volume of firms' deposits, the money supply dynamics will probably slow down little bit because of stagnation in households deposits. Since the fuel prices were raised by 0.5% and food prices decreased at lower than usual rate, we expect the CPI to reach 1.1% (core inflation inches up a bit to 1.5%).

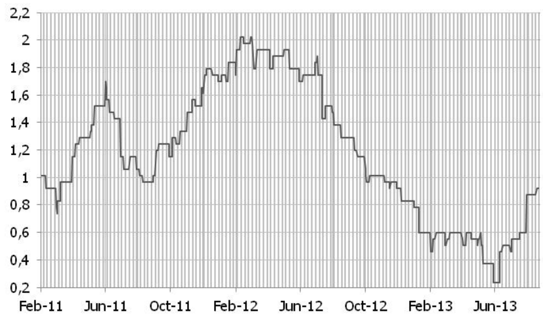
Polish data to watch: September 9th to August 13th

Publication	Date	Period	BRE	Consensus	Prior
Current account (m EUR)	11.09	Jul	87.0	58.0	574.0
CPI y/y (%)	13.09	Aug	1.1	1.1	1.1
M3 y/y (%)	13.09	Aug	6.1	6.3	6.5

Treasury bonds and bills auctions

Paper	Next auction	Last Offer	Last yield (%)	Prev auction
52 Week T-bills	-	3000	3.485	3/4/2013
2Y T-bond OK0116	-	5000	2.961	9/5/2013
5Y T-bond PS0718	-	5000	3.303	9/5/2013
10Y T-bond DS1023	-	3000	3.290	5/16/2013
20Y T-bond WS0429	-	150	3.464	5/16/2013

Reality vs analysts' expectations (surprise index* for Poland)



Comment

The positive surprise on PMI pushed index slightly up. Risk-neutral CPI reading is unlikely to bring any significant change to surprise index.

* Surprise index presents in a synthetic way how the market was surprised by macroeconomic releases (it is constructed on daily basis as weighted average of differences between selected releases and Bloomberg forecast consensus).

Our view in a nutshell

Fundamentals

- Available data confirm economy hit the bottom in Q1, recovery is in the pipeline.
- The upswing is driven by a rebound in real income and recovering private consumption. Low rates trigger rotation in households assets towards overnight deposits. Given the scale of slack in investment (infrastructure in particular) and consumption, rebound generated this way may be initially moderate (no more than 2% y/y growth rate in Q4 2013), albeit higher than current market consensus dominated by rather gloomy visions. Better business activity in the euro zone is going to strenghten the upswing trajectory, but we do not believe it is crucial for recovery to come at all.
- Polish government committed to the convergence path, though in a very unorthodox and elastic way. As the European Commission gave the government two additional years to bring the GG deficit down to 3%, budget amendement is coming at PLN +16 bn to deficit. This - along with the political business cycle - opens room for fiscal stimulation. Formal acceptance of the EC (and overal trend of consolidation's fatigue) suggests the market should digest this information easily.
- We witnessed the steepest disinflation phase in Polish history. 0.2% inflation growth was the lowest in the cycle. A spike in July - although to large extent exogenous - marks the beginning of new upward trends, both in headline and the core. Inflation stays subdued in historical standards, though.
- Rebound in growth and inflation practically erases easing bias in MPC. Therefore July rate cut definitely marked the end of the easing cycle. We expect first rate hikes to materialize in late 2014 and think that NBP projections of both GDP and inflation for 2014 are be too pessimistic.

Financial markets

- Local factors including economic upturn and liquidation of OFE assets suggest higher liquidity risk premium on Polish bonds. Global recovery (or monetary stimulus and liquidity withdrawal by the Fed) and rising core yields will additionally adversely affect Polish bonds. Such a set-up favors negative stance on Polish bonds. However, given the scale of recent movement we stay only neutral at the moment.
- The "wall of money" obscured the cyclicality of the Polish currency. This fact was revealed when expectations on QE tapering accelerated and the zloty dynamicaly breached 4.22/25 and broke out of the 1 year range. We expect a return below 4.20 when the economy accelerates visibly (long into H2) or/and rate hike expectations gain momentum (a turn of 2013/2014). At the moment QE tapering game is going to support the weakness of the zloty.

BRE forecasts

	2009	2010	2011	2012	2013F	2014F
GDP y/y (%)	1.6	3.9	4.5	1.9	1.1	3.0
CPI Inflation y/y (average %)	3.5	2.8	4.3	3.7	1.1	2.2
Current account (%GDP)	-1.6	-4.5	-4.9	-3.5	-1.9	-2.6
Unemployment rate (end of period %)	12.1	12.4	12.5	13.4	13.7	13.3
Repo rate (end of period %)	3.50	3.50	4.50	4.25	2.50	3.00

	2013 Q1	2013 Q2 F	2013 Q3 F	2013 Q4 F	2014 Q1 F	2014 Q2 F	2014 Q3 F	2014 Q4 F
GDP y/y (%)	0.5	0.7	1.3	2.1	2.4	2.5	3.1	3.2
Individual consumption y/y (%)	0.0	0.2	1.2	1.9	2.2	2.3	2.4	2.4
Public Consumption y/y (%)	-0.5	3.9	3.0	2.0	0.3	0.3	0.3	0.3
Investment y/y (%)	-2.0	-3.8	-1.8	-1.0	-0.5	1.8	3.0	3.8
Inflation rate (% average)	1.3	0.5	1.1	1.3	1.8	2.2	2.4	2.5
Unemployment rate (% eop)	14.3	13.2	13.2	13.7	14.3	13.0	12.9	13.3
NBP repo rate (% eop)	3.25	2.75	2.50	2.50	2.50	2.50	2.50	3.00
Wibor 3M (% eop)	3.39	2.73	2.70	2.70	2.70	2.70	2.70	3.20
2Y Polish bond yields (% eop)	3.19	3.07	3.10	3.20	3.30	3.30	3.30	3.30
10Y Polish bond yields (% eop)	3.94	4.34	4.80	5.00	5.00	5.10	5.20	5.50
EUR/PLN (eop)	4.18	4.33	4.20	4.10	4.05	3.95	3.90	3.90
USD/PLN (eop)	3.26	3.32	3.21	3.15	3.13	3.15	3.20	3.25

F - forecast

Economics

The NBP rates left unchanged and, according to NBP, they will remain at current level until the end of 2013

In line with the consensus MPC kept the rates unchanged leaving the reference rate at 2.5%. The Council introduced also in a formalized manner the forward guidance, i.e. a projected future path of interest rates. Rates are set to remain on hold until the end of the year. Polish forward guidance looks rather modestly in comparison with its global counterparts, which probably results from a fragility of a consensus achieved during MPC meetings.

The announcement stated a slight increase in the GDP growth rate, admitting however that it is still well below the potential growth rate. It was noted that, in the medium term, inflation is likely to remain subdued and inflation expectations are falling. Although governor Belka acknowledged the recovery is gaining momentum, he again stressed that, in his opinion, the growth is disappointedly low. It can indicate that, at least according to Belka, the period of record-low rates should be longer than the one pointed in the announcement. Governor Belka repeatedly emphasized the there is no CPI pressure or any other factor in favor of rate's hike.

The Council have also adopted Monetary Policy Guidelines for 2014. The document will be published probably later in August. Governor Belka indicated that the changes in the Guidelines will focus mainly on the tolerance of MPC for the departure of inflation from NBP's inflation target. Most likely the MPC will not change the strategy of stabilization of POLONIA rate around the reference rate. We expect rate hikes to occur in late 2014, as we forecast above-consensus growth rate of GDP in 2014. The market response was rather neutral, while the headlines were dominated by the pension reform.

The Prime Minister announced open pension funds (OFE) reform: redemption of government bonds held by OFE, voluntary character of new contributions

PM Tusk sketched some assumption of the new OFE reform. It has to be stressed that there is no official document summarizing the changes, no official regulation. Presented solution is a hybrid from three options published two months ago. The bonds held by OFE will be transferred (and redeemed) to state owned ZUS (app. PLN 120 Bn), what will decrease the debt to GDP ratio by 7.5pp. to approximately 45%. The OFE's assets will in effect shrink by 51.5%. Pension funds will not be allowed to invest the remaining assets in state bonds, but in equities, corporate bonds and deposits.

The voluntary option will refer only to new contributions, whereas in the original proposition it encompassed all assets. Polish citizens (participants of the pension system) will have three months to make decision whether to transfer their new contributions to the equity pillar held in OFE or rely entirely on the pay-as-you-go one (in case of lack of decision, the contributions will be transferred to the state system by default). Even if one decides to participate in equity funds, the accumulated assets will be gradually moved to ZUS (also responsible for paying retirement benefits) over the last 10 years of the working life. Additionally, the management fees will be halved.

Macroeconomic implications:

Although the proposition enlists the reduction of the debt thresholds by the amount implied by the liquidation of OFE's bonds, there is still the issue of EU's indebtedness limits that makes the debt reduction inevitable. It creates a fiscal space for stimulus next year and one can expect (as in our base-line scenario) significant contribution of government spending to the next year's GDP. According to our forecast, the GDP growth rate in 2014 will total 3% y/y. In such a scenario one can expect higher support for ruling party in forthcoming elections (both local in autumn 2014 and central in 2015).

Market implications:

It is a big thing! The market reaction to the announcement was rather emotional, while foreign analysts are still cautious in their assessments and it is rather unlikely that OFEs will start aggressively reducing their exposition just after the announcement. PM stressed that there are differences between Polish (equities remain in the OFE's portfolios) and Hungarian (nationalization) solutions. In case of investors' overreaction one can expect the NBP's interventions in order to stabilize the FX and FI markets. Despite the rating agencies' concerns regarding the delayed consolidation, the shrinking debt to GDP ratio may support Polish rating in the short term (in the longer horizon the growth rate will be a positive factor). Moody's and S&P have already confirmed its stable rating for Poland.

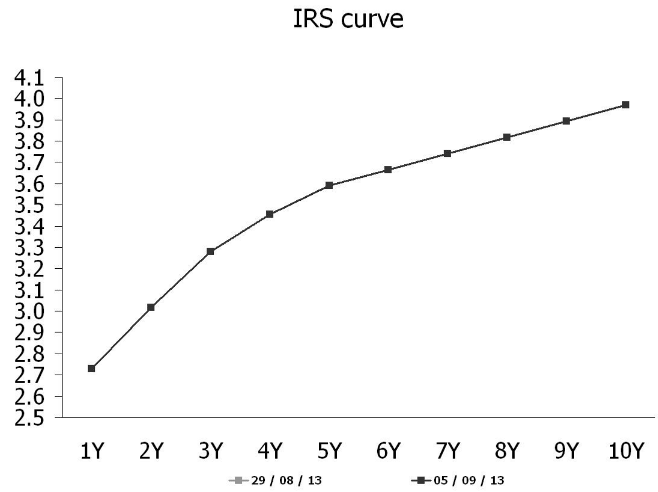
Redemption of bonds held in OFE's portfolios will dramatically change the FI market structure and switch the budget funding towards foreign investors (however the process will not be instantaneous). Additionally, the drop in the volume of outstanding bonds will decrease weights of Polish bonds in global indices and - as a consequence - decrease demand from foreign investors. In effect, the liquidity premium will rise and the yield curve will become steeper. The former is set to be exacerbated by the global drainage of liquidity. The latter effect will be magnified by the increased OFE's demand on the short-end as - until the regulation is implemented - OFEs will have to manage cash inflows without increasing portfolio's duration. Since OFEs are obliged to transfer 51.5% of their assets to ZUS (state bonds, state-guaranteed bonds and assets other than equity meaning most likely cash) but no less in state bonds than their share in OFEs portfolios from September 3rd , it may be the case that funds will have to overweight their bond portfolios in order to replicate the structure reported at this very date.

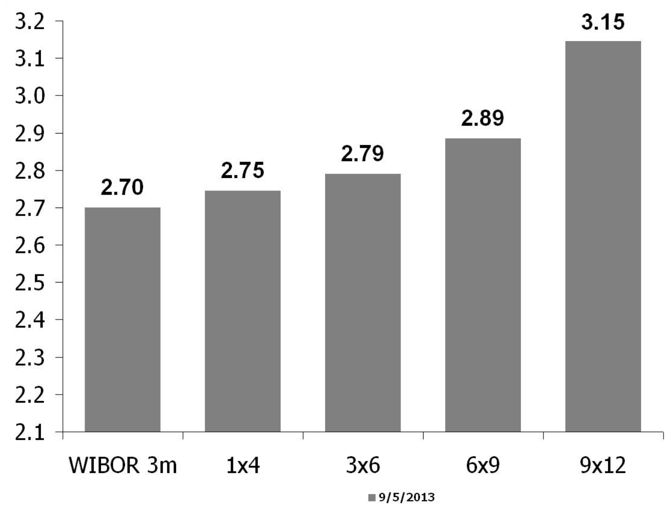
Government suggested that 51.5% of funds' assets will be transferred to state-owned ZUS. It can create extra demand from OFE on the short-end of the curve (if rebalancing, after few days of bond portfolio loosing on value, is done not via cash but by adding new bonds to portfolio). It is virtually certain that they will avoid longer papers. Since the proposition details remain unknown, it is hard to precisely assess the regulation impact on the markets (the earliest implementation date is seen at the end of this year but more realistically including so-called vacatio legis we may see budget transferring money to OFE by mid 2014; the 2014 budget proposal includes estimates of domestic debt funding supporting such reasoning). Another issue of great relevance that is yet to be determined is whether the inflows of new contributions (or, indirectly, the fraction of participants choosing OFE, or more precisely its equity part) will offset the outflows resulting from the obligation of gradual assets transfers to ZUS over 10 years before retirement age. The earlier mentioned negative effects may be strengthened if NBP let's PLN depreciate what will generate negative feedback loop between currency and debt and therefore - faster exit of foreign investors.

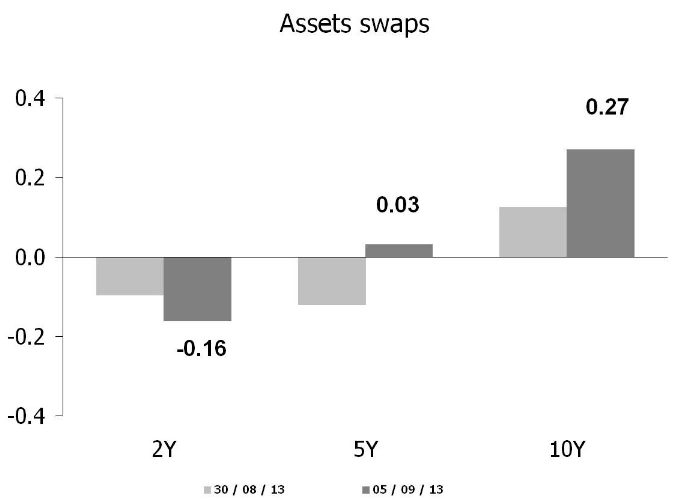
Fixed income

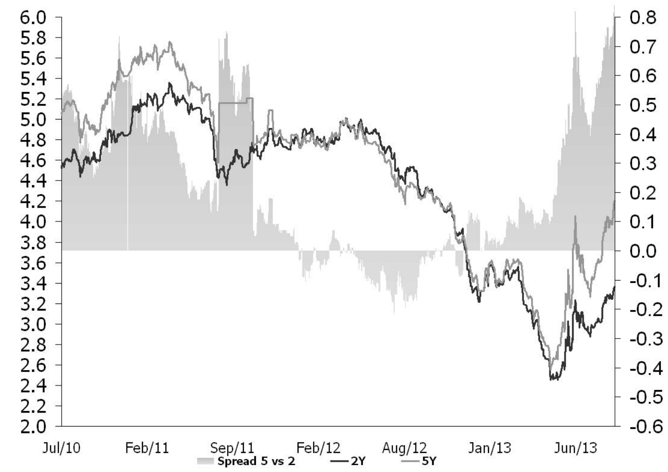
We had Pension Funds

This week on fixed income was dominated by the news that Open Pension Funds are going to disappear from the bond market. Just like that, one day before huge auction we lost significant market participant. Obviously this caused massive volatility and selloff on bonds. Yield of DS1023 went up 35bp to 4.93 currently. Considering circumstances, demand on auction was solid (almost 3bln of OK0116 and same amount of PS0718 was sold), probably because news was not a big surprise. But still, we see pressure to sell Asset Swaps, especially on longer end of the curve. We think that current forward levels (like 1Y3Y around 5.20%) are too high, but we advise to wait for a clear signal to get involved on this crazy market.





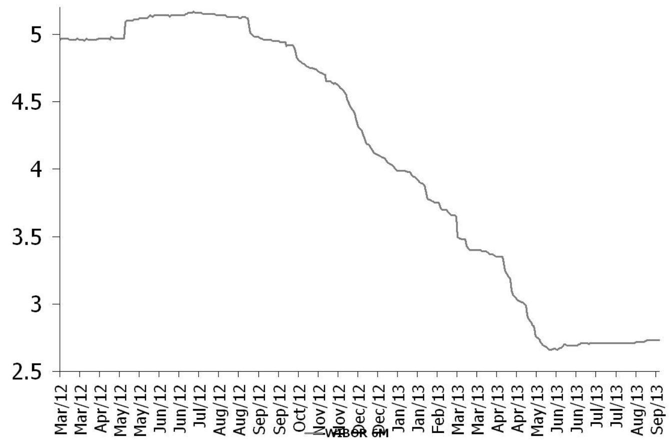




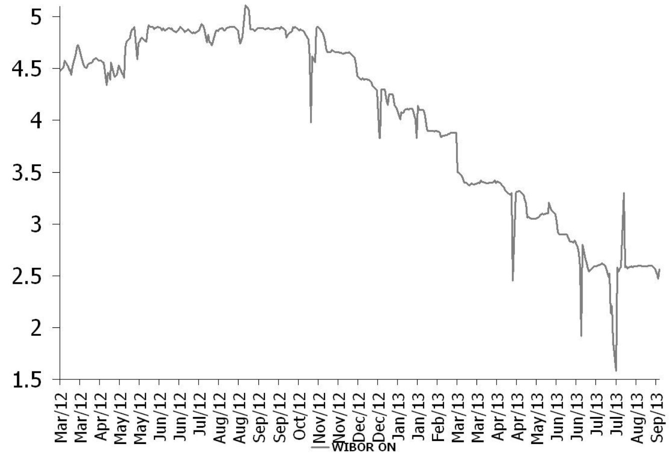
Money market

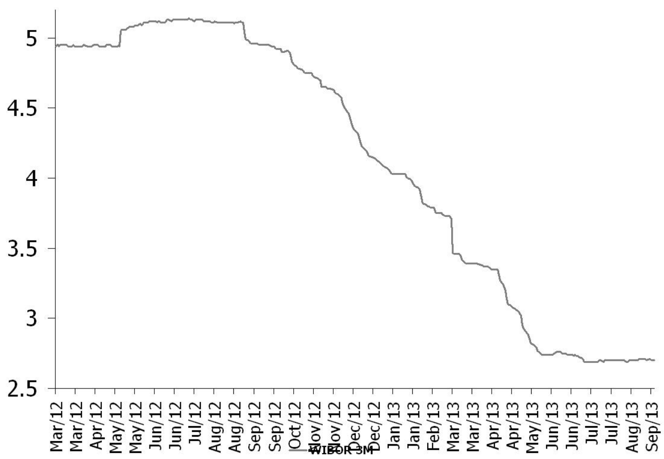
MPC without surprises Huge surplus of cash in the system for the whole week pushed the shortest rates down. The move would be much more intense if not the beginning of the reserve period. Today quite a substantial OMO and demand for money bills (133 vs 131 bln pln), that lefts the market short for approximately 3 bln pln. This should bring the polonia index again near the main market rate.

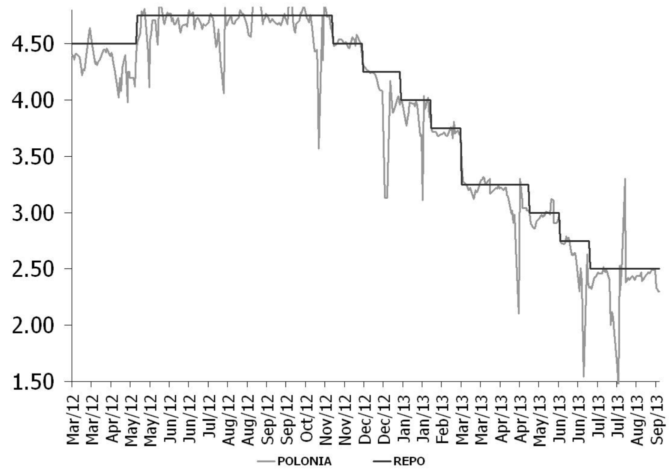
The MPC did not change the rates as expected, but communicated local version of the forward guidance, a very short term forward guidance. . . . Till the end of this year.



OFE reform made an earthquake OFE reform made an earthquake on the Warsaw Stock Exchange and on the bond market. The move was very rapid and we perceive it as emotional rather then well analyzed. A thorough analysis is just impossible since we do not know any crucial details of the reform. The legal act is not ready, it is probably just being written and can implement some solutions of a great impact to the whole reform and its final shape. Having said that we suggest to stay calm. For the short end of the curve we like having spread between polonia and the wibor (sell ois at current levels and pay fra on any dips).





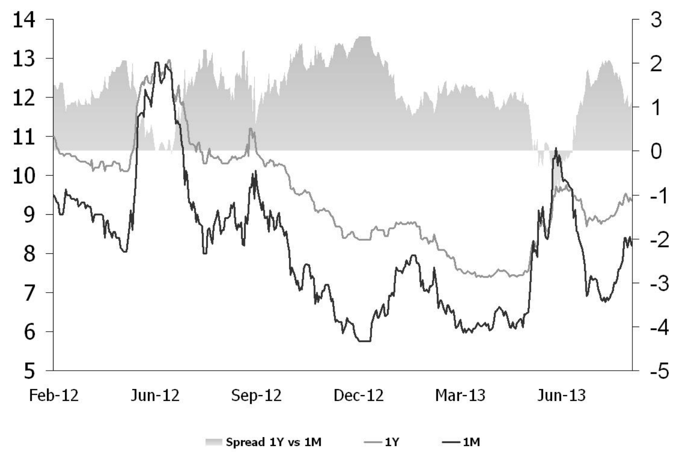


Forex

PLN weaker again The government decision to decompose Polish Pension System was the reason for the PLN weakness. We briefly broke above 4.30 resistance and touched 4.31 before retracing below 4.30. The market opinions are really mixed about it but it was really bearish on the Polish bonds market, and affected PLN in the consequence. It's was a unique situation when local factors prevailed, but now all eyes are back to US NFP for gauging the potential FOMC decisions next week. We think that tapering is already priced to some extent . . .

Higher again Vols are higher again due to weaker PLN, and as we getting closer to crucial FOMC meeting. The gamma especially was in demand and price of it rose significantly. EUR/PLN 1 month is now 9.0% mid versus 8.25% last Friday. 3 month EUR/PLN ATM is fixing at 9% (0.5% higher) and 1 year is 9.8% (0.4% higher). The skew was in demand, with risk reversals higher by roughly 0.3%. The currency spread (difference between USD/PLN vol against EUR/PLN vol) was unchanged which is slightly surprising as EUR/USD headed south.

EURPLN volatility



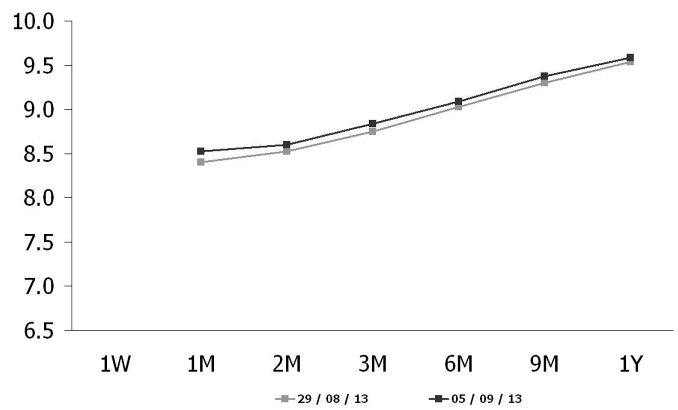
Short-term forecasts

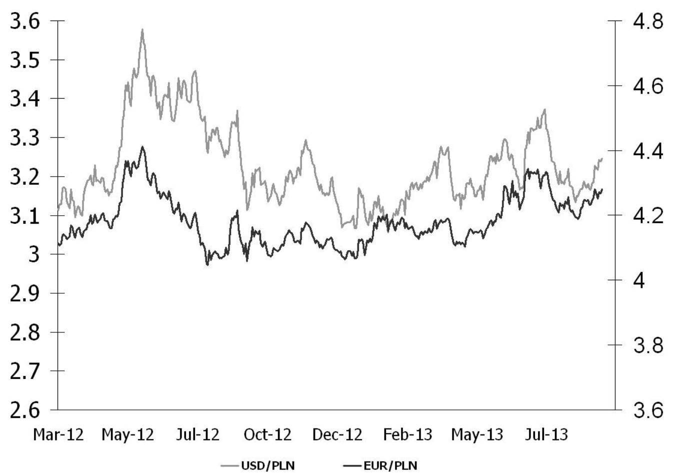
SPOT Main supports / resistances:
EUR/PLN: 4.2000 / 4.3400
USD/PLN: 3.0500 / 3.3000

Fade extremes Last week short at 4.28 was closed with small profit. We still assume we are in the range , which now would be the most probably 4.22/4.32. We are more keen to sell spikes with ideal entry level at 4.32 and stop above 4.35 and hopes for a move below 4.25. We think the upside is still NBP protected, and the FOMC actions are the most likely priced in to same degree.

Derivatives With the weaker PLN, volatility levels are rising just shy of this year highs. But the realized volatility is not really confirming that move. The levels above 4.32 will the most likely attract CB attention with a intervention chances rising significantly. We are still preferring to be neutral, long in the backend but on the other hand we think it is likely that the frontend is at levels witch should encourage sellers if realized volatility will not catch up with a rising implied vols.

EUR/PLN volatility curve





Bias from the old parity (%)

Market prices update

Money market rates (mid close)								FRA rates (mid close)				
Date	FXSW 3M	WIBOR 3M	FXSW 6M	WIBOR 6M	FXSW 1Y	WIBOR 1Y	1x4	3x6	6x9	9x12	12x15	6x12
8/30/2013	2.37	2.70	2.52	6.49	2.80	6.59	2.72	2.74	2.84	3.03	3.23	2.98
9/2/2013	2.36	2.71	2.50	2.63	2.80	2.66	2.72	2.75	2.86	3.05	3.28	2.97
9/3/2013	2.35	2.70	2.53	2.63	2.85	2.66	2.73	2.76	2.86	3.06	3.31	3.04
9/4/2013	2.32	2.70	2.49	2.63	2.82	2.66	2.72	2.76	2.89	3.10	3.35	3.04
9/5/2013	2.31	2.70	2.52	2.63	2.84	2.66	2.75	2.79	2.89	3.15	3.45	3.13

Last primary market rates							
Paper	Au. date	Maturity	Avg. price	Avg. yield	Supply	Demand	Sold
52W TB	5/30/2011	5/30/2012	95.57	4.58	600	2667	505
OK0114	8/10/2011	1/25/2013	89.58	4.58	5000	4934	1889
PS1016	10/19/2011	10/25/2016	98.44	5.11	3600	11200	3638
DS1021	7/21/2011	10/25/2021	99.53	5.80	3000	5608	3000

Fixed income market rates (closing mid-market levels)								
Date	1Y WIBOR	1Y T-bill	2Y IRS	OK0113	5Y IRS	PS0416	10Y IRS	DS1019
8/30/2013	6.590	3.353	3.292	3.275	3.420	3.351	3.630	3.873
9/2/2013	2.660	3.114	3.263	3.148	3.370	3.270	3.575	3.755
9/3/2013	2.660	2.992	3.218	3.137	3.325	3.237	3.525	3.759
9/4/2013	2.660	2.992	3.218	3.137	3.325	3.237	3.525	3.759
9/5/2013	2.660	2.992	3.218	3.137	3.325	3.237	3.525	3.759

EUR/PLN 0-delta stradle				25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
8/30/2013	8.15	8.58	8.93	9.43	9.43	2.94	0.78
9/2/2013	8.33	8.60	8.88	9.33	9.33	2.94	0.78
9/3/2013	8.43	8.60	8.94	9.44	9.44	2.87	0.79
9/4/2013	8.20	8.63	8.93	9.35	9.35	2.94	0.80
9/5/2013	8.53	8.84	9.09	9.59	9.59	2.97	0.79

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
8/30/2013	4.2654	3.2209	3.4632	3.2839	1.4202	0.1656
9/2/2013	4.2507	3.2164	3.4497	3.2391	1.4177	0.1653
9/3/2013	4.2720	3.2433	3.4681	3.2687	1.4188	0.1661
9/4/2013	4.2673	3.2387	3.4582	3.2523	1.4163	0.1655
9/5/2013	4.2805	3.2463	3.4549	3.2496	1.4197	0.1660

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